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TSPL

SUBJECT: EU EAGER TO WORK WITH U.S. ON CAP AND TRADE SYSTEMS

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USEU would like to thank Embassy London for its assistance in preparing this cable.

1. (SBU) Summary: EU Commission officials, industry reps, climate traders, and NGOs, are eager for a U.S. cap and trade system and anxious to share their experiences on the 2008 revision process of the EU's Emissions Trading Scheme (ETS). Seeking U.S. leadership on climate change, all aspire to a global carbon market, commencing with a common transatlantic market. Thus, the EU Commission is pushing to establish a U.S.-EU task-force to explore ways to link the ETS with a U.S. cap and trade system. The overwhelming consensus is that once a transatlantic market is established, the other major economies will join. The main recommendations for developing a cap and trade system, according to the different groups:

-- any carbon market should aim to "reward the efficient and penalize the inefficient," drive technology development, and foster sustainable growth in developing economies;

-- there are three keys to linking systems: (1) the ambition level of the caps must be compatible, including the distribution system for emissions allowances; (2) limiting safety valves or price floors in the carbon price; and (3) comparable level of quality and quantity of offsets;

-- in the absence of an international agreement, there will be continuing pressure to level the playing field vis-a-vis imports if industries in other countries are not required to purchase carbon credits. End Summary.

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EU anxious for U.S. to take leadership role  
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2. (SBU) Following the December 2008 enactment of its comprehensive internal climate legislation, the EU has now set its sights on the U.S. One component of the EU's Climate and Energy package was the revision of its emissions trading scheme (ETS) and the extension to its third phase. (Note: ETS entered in force in 2005 and phase I ran from 2005 to 2008, phase II runs from 2008 to 2012, and phase III commences in 2013. End note.) As we consider whether to develop our own cap and trade system, Europeans are eager to engage us in hope of eventually linking the two systems, so much so, that the EU has proposed a U.S.-EU task force on carbon markets.

3. (SBU) EU leaders, such as Commission President Barroso, Environment Commissioner Dimas, and several parliamentarians are anxious for the U.S. to resume the leadership role on climate. "The EU wants the U.S. back in the mix," said MEP

Avril Doyle (EPP-ED, IR) the rapporteur for the ETS legislation. "The U.S. should be leading world debate." However, the EU defines the global climate agreement as distinct from the development of a global carbon market. The former, as it argues in the recent Communication on the Copenhagen process, should be handled under the UN Framework.

(Note: The EU's objectives for Copenhagen are: (1) mitigation targets, (2) financing mechanisms, and (3) international offsets. End note.) Linking carbon markets, on the other hand, is a critical aspect to addressing climate change, but should be handled under bilateral and other multilateral processes. Indeed, Robert Stavins, co-chair of Harvard's Project on International Climate Agreements, told us that even if no agreement is reached in Copenhagen, an international carbon trading system would suffice. The EU's ultimate goal is a global carbon market, but one that is led by an OECD-wide market, preferably by 2015. EU leaders view the ETS as global model to which other schemes can be docked and see the U.S. as a natural partner. Germany's foreign minister Steinmeier has called for a "powerful new trans-Atlantic (carbon) market." Doyle said the "U.S. and EU can provide the building blocks for an international system."

Combined, "our leverage will be irresistible to countries that seek to trade with us."

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EU realizes difficulty in designing a system  
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¶4. (SBU) Despite their (over)eagerness to have the U.S. rejoin the fold, the Europeans realize that designing a cap and trade system is a time consuming, complex process. In this respect, they are anxious to share their experiences. "We identified a lot of problems during the second phase, especially allocation of credits, carbon leakage and affect on jobs," said Dimas. A report prepared for the Parliament

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cited a number of deficiencies in the first two phases of ETS, notably over allocation of credits, distortion in the allocations to member states and windfall profits for the power sector.

¶5. (SBU) Doyle said the first objective is to "establish a functioning carbon market" with participation by the political, scientific, and industrial communities. She stressed the importance of buy-in from the latter: "let industry know the government will support it through the transition. There is no need to go for the jugular at the outset; the legislation can be strengthened in the future." Industry representatives stressed the need for incentives to develop technology. NGO representatives agreed, urging that new legislation "reward the efficient and penalize the inefficient." Sanjeev Kuma of WWF said cap and trade legislation should "drive technology, reduce emissions, and build capacity in developing countries."

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If the U.S. leads, others will follow  
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¶6. (SBU) Government and industry leaders alike believe a transatlantic carbon market would open the way to a global market. Dimas predicted that if the U.S. and EU link trading systems, Australia and Japan would quickly enter. The general consensus is that China would be compelled to join a U.S.-EU based carbon market. Jill Duggan of the UK's Department of Energy and Climate predicted that China would enter such a market within ten years of its inception, but without U.S. participation, China would be less inclined. Duggan said that linked systems would "provide more certainty and stability for industry." Industry representatives concurred, stating that a global system would provide a level playing field, minimize trade barriers, and encourage Russia, China, and the Middle East to follow suit. In addition to attracting emerging economies and diversifying abatement

options, linkage would increase the scale of the market, improve the liquidity of carbon credits, and more efficiently allocate resources.

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Linking requires substantial coordination  
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¶17. (SBU) Linking the EU's ETS with a U.S. cap and trade system may sound ideal in the abstract, but several complications could arise should U.S. legislation be enacted.

Thus, understanding the differences between schemes will be necessary to determine the expediency of linkage. Government, industry, and NGO officials are in general agreement that there are three keys to linking systems. First and foremost, the ambition level of the caps must be compatible. Too large a divergence will cause a large fluctuation in market prices and drive allowances in one direction. Second, the existence of safety valves or price floors in one system where none exist in the other could provide a "money printing machine" for one of the economies. Finally, the quality and quantity of offsets must be comparable. If it is too easy to gain credit through offsets, the carbon price will be driven by one market, again causing an imbalance.

¶18. (SBU) Setting the emissions cap will be a key component of the U.S. system that will impact the prospects for linkage. The EU learned the hard way during the early phases of the ETS by establishing an emissions cap that was too high to stimulate reductions. The EU based its initial cap on "business-as-usual" predictions without factoring in other considerations such as economic growth/decline and fuel costs. At the time, it also had to deal with limitations on available data and intense lobbying by affected sectors. The result was an early flood of carbon allowances in the market and a sharp decline in their price. Targets should be based on historical data for emissions over an extended period and should use the best available technology as the baseline.

¶19. (SBU) Complications could arise if the margin between the market prices is too great. Market prices will be greatly influenced by the emissions cap, the amount of credits and manner in which they are distributed, and any cost-containment measures. Other factors to be considered include offsets and trade restrictions, such as border adjustment measures (BAMs). Nevertheless, Dimas said "once the U.S. system is designed, we will cooperate to link them." Doyle and Duggan concurred, noting that the EU institutions would work to harmonize the ETS with U.S. legislation.

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Indeed, the EU Parliament commissioned a study for this very purpose. In the meantime, EU officials will seek to influence the U.S. legislative process to encourage the highest degree of compatibility. Duggan said an internationally compatible system is in the interests of the U.S.

¶10. (SBU) Another aspect our European colleagues will follow closely is the distribution and handling of emissions allowances, which has been a contentious issue for the EU. It began during the early phases of the ETS, when power companies were given free allowances to help ease what Duggan termed "the burden of compliance." Given the inflated cap, the power companies reaped windfall profits from increased rates passed on to consumers and revenues from the free emissions credits. This led to a debate over whether credits should be given away or auctioned. Doyle acknowledged that the EU was under political pressure to provide power companies with free credits, most recently by the coal-dependent, eastern member states. Notwithstanding the influence of regulated sectors to receive free credits, traders Neil Eckerts of the Climate Exchange and Patrick Birley of the European Climate Exchange advocated for the U.S. to issue free credits. Birley compared emissions caps

to a tax and likened auctioning of credits to a double tax on businesses. He said credits should be provided except where the covered emitter has a monopoly. In theory, free credits would stem carbon leakage, but there is a risk that companies would sell the credits and relocate operations to a cap-free jurisdiction.

¶11. (SBU) Proponents of auctions contend they are necessary to abate emissions and promote innovation. Chris Leeds of Barclay's Bank said that if companies must purchase emissions allowances, they will purchase what they need and seek to reduce emissions to cut costs. If the allowances are free, they will gobble up what they can get, eliminating incentives to reduce emissions. Many business representatives adamantly advocated the "polluter pay principle"; "don't reward dirty companies" they urged, citing the example of the power companies. Doyle said that auctions, while imposing costs on businesses, generate revenues which can be used to offset costs to consumers or fund new technologies. The third phase of the ETS will combine auctioning with free credits for certain sectors. If the U.S. were to implement an auction only scheme, a Commission official said the EU would revert to a total auction scheme if the two were to be linked.

¶12. (SBU) Most all of our interlocutors stressed the need for minimal intervention in the market. Birley warned against price ceilings. He said the object of a cap and trade system is to encourage abatement, which a ceiling could inhibit. Leeds also spoke against cost containment. He and Doyle warned that excessive intervention could chill investment. (Note: Not all of Doyle's fellow parliamentarians subscribe to this view, and this proved to be very contentious in Parliamentary debates. End note.) The EU has no controls in place, and if the U.S. were to do so, it could impact on linkage. For instance, if the systems were linked and the U.S. had a price ceiling of \$30 dollars per ton, all EU credits would become subject to the same ceiling. Doyle said the market can be regulated, but the price should not be interfered with. To the extent necessary, governments can influence the price through auctions and the availability of credits. In fact, the ETS does have a price stability mechanism which authorizes the Commission to intervene only if the price is too high or low, but even then, the amount of power given to the Commission is very limited. Leeds also recommends unlimited banking of credits, which, if the cap is properly set, could increase abatement in the short-term. Borrowing presents another potential obstacle. If one scheme permits borrowing from future allocations, it could draw down the price of carbon. Under the ETS, credits can be banked for future use, but they cannot be borrowed against future allocations.

¶13. (SBU) Offsets and use of the clean development mechanisms can also pose a challenge to linkage. Dimas noted the U.S. fondness for sinks is a potential obstacle, given the EU's skepticism on reforestation, but he believes this can be worked out. Environmental NGOs were even more blunt, saying (with some disregard to the overall carbon level) the U.S. use of extensive re-forestation offsets would make linking the systems impossible. Birley said that CDMs are laborious to implement and difficult to manage. If schemes are to be merged, CDMs would have to be well regulated "to maintain the quality of the currency." Industry representatives noted the need to find common ground on CDMs, which they suggested be

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capped. One proposal is to specify permissible offsets in domestic and international markets. This is one area where the EU expects the UN process to drive the discussion, as the EU plans to argue for a global reassessment of offset mechanisms to ensure the quality is sufficient to effect change. As one EU official put it, "in all projects, one of the two partners has to suffer," or there will be no true emissions reduction.

¶14. (SBU) A final issue that came up in our discussions was

treatment of imports from non-regulated economies. Both in the United States and in the EU, there will be continuing pressures to "level the playing field" vis-a-vis imports if companies in the United States or the EU have to purchase carbon credits and their exporting competitors do not. One of the options that has been proposed in both jurisdictions is a border adjustment mechanism (BAM) which could, for instance, require importers to purchase credits or to simply pay an offsetting charge. A unilateral BAM, however, can present challenges under international trading rules, and the EU in its climate package postponed consideration of such unilateral measures until 2011, when the results of international discussions are clearer.

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Comment: Working Group Concept Likely Useful  
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16 (SBU) The EU's checkered experience with ETS has demonstrated amply that devising a successful carbon emissions trading scheme within an economy is tremendously difficult; building a linked and eventually a global carbon market will be much more so. The EU's proposal to develop a U.S.-EU task force on carbon markets, with an eye toward eventual linking, thus would seem useful. The EU, having experienced many of the same obstacles and pitfalls likely to be encountered in the U.S., in particular with "carbon leakage," free allowances vs. full or partial auctioning, and the definition of "economy-wide," can provide insights that could help as the U.S. considers this option. Additionally, given the anxiousness of the EU to link the systems, a task force could provide a venue to encourage revisions to ETS to promote harmonization, which Commission officials have stated they are prepared to do.

MURRAY

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